

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Fixed Income –
Currency Hedging Policy Revision

ITEM NUMBER: 5

ATTACHMENT(S): 3

ACTION: X

DATE OF MEETING: December 4, 2002

INFORMATION: _____

PRESENTER(S): Michelle Cunningham, CFA
Glenn Hosokawa, CFA

EXECUTIVE SUMMARY

Last month, based upon the recommendation of staff, Callan Associates, and Pension Consulting Alliance following the completion of a series of presentations regarding the suitability of the current benchmark for the currency component associated with the Fund's strategic allocation to non-dollar equity assets, the Investment Committee reaffirmed the adoption of an unhedged policy benchmark and adopted the following statement of philosophy regarding currency management:

“CalSTRS believes that the Fund's Currency Management Program should emphasize the protection of the value of its non-dollar equity assets against a strengthening U.S. dollar.”

As a result, the Currency Hedging Program Policy Manual has been updated to reflect these actions.

DISCUSSION

In addition to these updates, staff and Pension Consulting Alliance (PCA) have taken this opportunity to review the policy manual for any further necessary changes, since the last revision was nearly two years ago. Consequently, we are submitting the inclusion of the Investment Officer I level in the daily trading authorization limits (Policy #9), since it had been excluded previously. Other cosmetic changes are being suggested as well in order to make this policy manual consistent with others that have been updated recently. **Attachment 1** represents a marked-up policy manual, illustrating the suggested changes. **Attachment 2** is the proposed revised Currency Hedging Program Policy Manual.

Besides the policy updates, the Investment Committee also authorized staff to conduct further research into implementing the Fund's philosophy for currency management. The objective for this research is to develop implementation alternatives, including an evaluation of CalSTRS' current implementation methodology and, if applicable, policy revision suggestions for the Committee's consideration at some future meeting. As a result, it is anticipated that staff will assemble a team similar to that which has conducted the currency management research to date.

RECOMMENDATION

Staff and Pension Consulting Alliance recommend the following actions for the Investment Committee's consideration and approval:

- 1) That the Board approves the changes to the Currency Hedging Program Policy Manual to reflect the addition of the statement of philosophy and the inclusion of the Investment Officer I in the daily trading authorization limits.
- 2) That the Board approves the attached Board Resolution (**Attachment 3**)

Date prepared: _____

By:

Dan Depner
Assistant Investment Officer

Glenn Hosokawa, CFA
Principal Investment Officer

Michelle Cunningham, CFA
Director of Fixed Income

Review & Concur:

Christopher J. Ailman
Chief Investment Officer

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CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

CURRENCY HEDGING PROGRAM *Policies Policy Manual*

INVESTMENT BRANCH
~~October 2000~~ *December 2002*

California State Teachers' Retirement System
Currency Hedging Program
~~Policies~~ *Policy Manual*

TABLE OF CONTENTS

Introduction.....	1
CalSTRS Currency Hedging Program Policies.....	3
CalSTRS Currency Hedging Program Flowchart.....	2
CalSTRS Currency Hedging Program Glossary.....	5

**California State Teachers' Retirement System
Currency Hedging Program
Policies**

INTRODUCTION

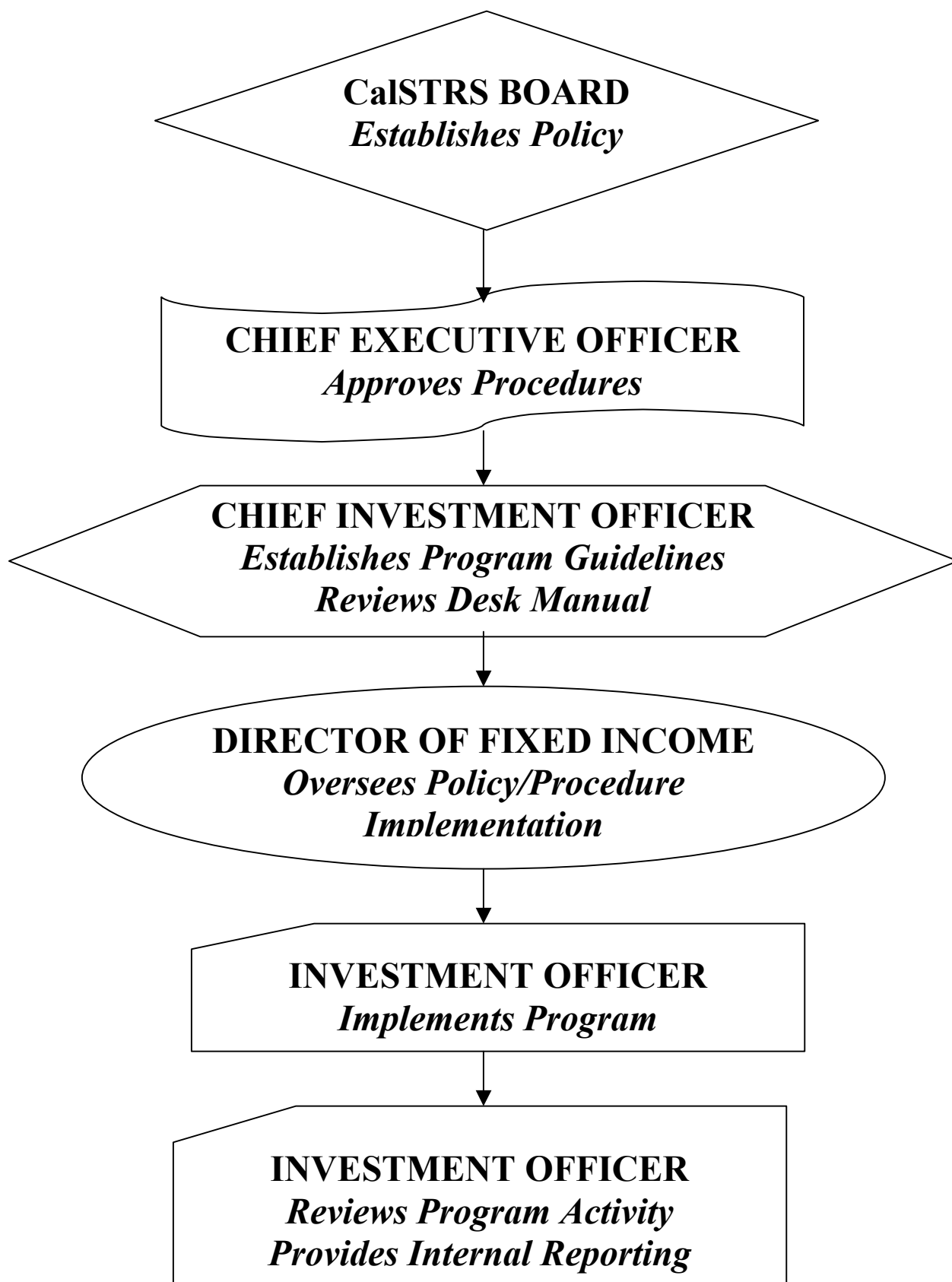
The California State Teachers' Retirement System (CalSTRS, System) has adopted a global investment strategy, which includes a 25% strategic allocation to non-dollar investments. Whereas domestic assets are exposed to market risk, which is the probability that financial assets will rise or fall in value, non-dollar assets have two sources of risk: 1) local market risk and, 2) currency risk. For example, a portfolio of French assets may increase in value by 10% to a local (French) investor, but a U.S. investor, such as CalSTRS, would receive the 10% return plus or minus any change in the French franc to U.S. dollar currency valuation. Since currency exchange rates are not stable, the likelihood that an exchange rate will remain constant over time is very small. It is this risk relative to currency fluctuations that gives rise to currency strategies.

As described above, non-dollar investments are expected to represent a considerable portion of CalSTRS' investment portfolio. Furthermore, fifty percent (50%) of the non-dollar assets are targeted to be managed on a passive basis. Because the return associated with currency is a substantial component of the total rate of return of non-dollar investments, the currency strategy at CalSTRS could have a significant impact upon the total rate of return of the non-dollar investment portfolio. Therefore, in 1995, CalSTRS developed and implemented a Currency Hedging Program designed to reduce the risk of the passively managed segment of the non-dollar equity portfolio. As a result, controlled amounts of short currency positions are established in approved currencies when there is the risk that the U.S. dollar may strengthen.

This document outlines the approved policies of CalSTRS' Currency Hedging Program that have been designed to address the System's philosophy with respect to the potential risk to the portfolio that currency represents, and to clarify the role that currency hedging plays within the context of portfolio management. A flow chart is included to provide context for the policies within the general process of implementing the Currency Hedging Program. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.

California State Teachers' Retirement System
Currency Hedging Program
Policy Manual

FLOWCHART



California State Teachers' Retirement System
Currency Hedging Program
~~Policies~~ *Policy Manual*

PROGRAM POLICIES

~~October 2000~~ *December 2002*

The following *document* represents the approved policies to be utilized in the management of CalSTRS' Currency Hedging Program. They are designed to address the System's philosophy with respect to the potential risk to the portfolio that currency represents, and to clarify the role that currency hedging plays within the context of portfolio management. Policies approved by the CalSTRS Board cannot be altered without explicit approval from the CalSTRS Board. *A flow chart is included to provide the context for the policies within the general process of implementing the Currency Hedging Program. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.*

1. **Laws and Statutes** – The Currency Hedging Program is to be managed in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries, in accordance with California State Teachers' Retirement Law and other applicable statutes.
2. **Statement of Philosophy** – *CalSTRS believes that the Fund's Currency Management Program should emphasize the protection of the value of its non-dollar equity assets against a strengthening U.S. dollar.*
3. **Program Objective** – The strategic objective for the Currency Hedging Program is to reduce the risk of the passively managed segment of the non-dollar equity portfolio by establishing controlled amounts of short currency positions in approved currencies when there is the risk that the U.S. dollar may strengthen. The performance of the Currency Hedging Program shall be evaluated in comparison to the MSCI EAFE Index on an unhedged basis
4. **Counterparty Exposure** – A counterparty's inclusion within the Currency Hedging Program shall be evaluated, based upon the expertise and financial capacity of the firm. Due to the extended settlement practices, credit quality and size limitations will be established and documented within the Procedures Manual, and are subject to change as conditions warrant.
5. **Hedge Ratios** – Up to fifty-percent (50%) of the total market value of the passively managed segment of the non-dollar equity portfolio may be hedged. In addition, no more than one hundred-percent (100%) of each individual currency may be hedged. (No net short positions are permitted.) Any combination of approved countries can be utilized to reach the fifty-percent (50%) maximum limitation; however, no cross-hedging is permitted.

California State Teachers' Retirement System
Currency Hedging Program
~~Policies~~ Policy Manual

6. **Approved Countries** – Given the substantial portion of the transactions and the market capitalization of the MSCI EAFE Index that they represent, the countries for which hedging currency exposure is permitted will be limited to those represented by the Euro (Germany, France, Spain, etc.), Japan, Switzerland and the United Kingdom.
7. **Permitted Instruments** – Currency forwards, with a maximum value date of six months from the spot date, shall be utilized to establish the currency hedges. The use of currency futures, options on currencies, or options on currency futures is prohibited.
8. **Authorized Signers** – Authorization letters which indicate who may transact business for the CalSTRS Currency Hedging Program shall be sent with a copy of the most recent Currency Hedging Resolution, initially at the time an account is opened, and then periodically to all currency hedging counterparties with whom CalSTRS conducts business. Whenever a change in authorized signers takes place, the counterparties shall be notified in writing, within 24 hours in the event of termination, and as soon as possible in the event of a newly authorized signer(s).
9. **Authorization Limits** – The following daily limits apply with respect to the approval of currency hedging activity within the Currency Hedging Program:

•	<i>Investment Officer I</i>	<i>\$25 million</i>
•	Investment Officer II	\$50 million
•	Investment Officer III	\$100 million
•	Principal Investment Officer	\$250 million
•	Director of Fixed Income	\$500 million
•	Chief Investment Officer	\$1 billion
10. **Trade Processing** – Prior to being processed to Operations, all currency hedging tickets shall be authorized within ~~these limits~~ *the limits noted above* and countersigned by two Investment Officers *within Fixed Income*.
11. **Business Plan** – The Currency Hedging Program will be managed in accordance with an annual Business Plan. This plan will include a broad overview of the Currency Hedging Program, with the key issues associated with the management of the program, as well as future objectives and a resource allocation analysis.
12. **Delegation of Authority** – The management of CalSTRS' Currency Hedging Program is delegated to staff within the boundaries established by these policies and the processes described within the Procedures Manual.

California State Teachers' Retirement System
Currency Hedging Program
~~Policies~~ Policy Manual

- 13. Reporting** – Staff will prepare a report summarizing the activities associated with the management of the Currency Hedging Program on a monthly basis for the Chief Investment Officer. The report shall provide program information, including outstanding positions, realized and unrealized gains/losses, and a counterparty review.
- 14. Board Review** – The Board shall administer and review this policy periodically, as it deems appropriate, in keeping with the investment standard.

ADOPTED BY THE TEACHERS' RETIREMENT BOARD ON JULY 12, 1995
REVISED ON SEPTEMBER 11, 1996
REVISED ON JANUARY 7, 1998
REVISED ON JUNE 2, 1999
REVISED ON OCTOBER 11, 2000
REVISED ON DECEMBER 4, 2002

California State Teachers' Retirement System
Currency Hedging Program
~~Policies~~ *Policy Manual*

GLOSSARY

~~**APPROVED CURRENCIES** – The currencies of the countries where hedging exposure is permitted. The countries will be limited to those represented by the Euro, Japan, Switzerland and United Kingdom. (See Policy #6)~~

CROSS-HEDGING – Hedging the risk of one currency by buying or selling another currency. Because the different currencies are similar but not identical, additional risk may incur.

COUNTERPARTY – An individual or organization on the opposite side of a trade.

CURRENCY – Any form of money that is in public circulation.

CURRENCY HEDGING – A strategy used to offset the risk associated with holding non-dollar currency.

CURRENCY RISK – The risk related to currency fluctuations. For CalSTRS, it is the fluctuation of any foreign currency compared to the U.S. dollar.

EXTENDED SETTLEMENT PRACTICES – Settlement for currency forwards takes place on the value date. Value dates for CalSTRS Currency Hedging Program are ~~limited to the one to six month area~~ *not to exceed six months*.

HEDGE RATIOS – The number of currency forwards sold against a position in the underlying currency in order to hedge the position.

MSCI EAFE INDEX – The Morgan Stanley Capital International Europe, Australia & Far East Index.

NON-DOLLAR – Investments made in currencies other than the U.S. dollar.

PRUDENT MANNER – The fiduciary is required to act in a manner appropriate in keeping with the investment standard, in the best interest and for the sole benefit of CalSTRS' participants and beneficiaries.

SHORT CURRENCY POSITION – The act of selling currency in which the seller does not have an underlying position.

VALUE DATE – Term used in relation to foreign currency to indicate the date when transferred money becomes available to the depositor.

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CURRENCY HEDGING PROGRAM *Policy Manual*

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**California State Teachers' Retirement System
Currency Hedging Program
Policy Manual**

TABLE OF CONTENTS

CalSTRS Currency Hedging Program Policies.....	1
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CalSTRS Currency Hedging Program Glossary.....	5

**California State Teachers' Retirement System
Currency Hedging Program
Policy Manual**

PROGRAM POLICIES

December 2002

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Currency Hedging Program
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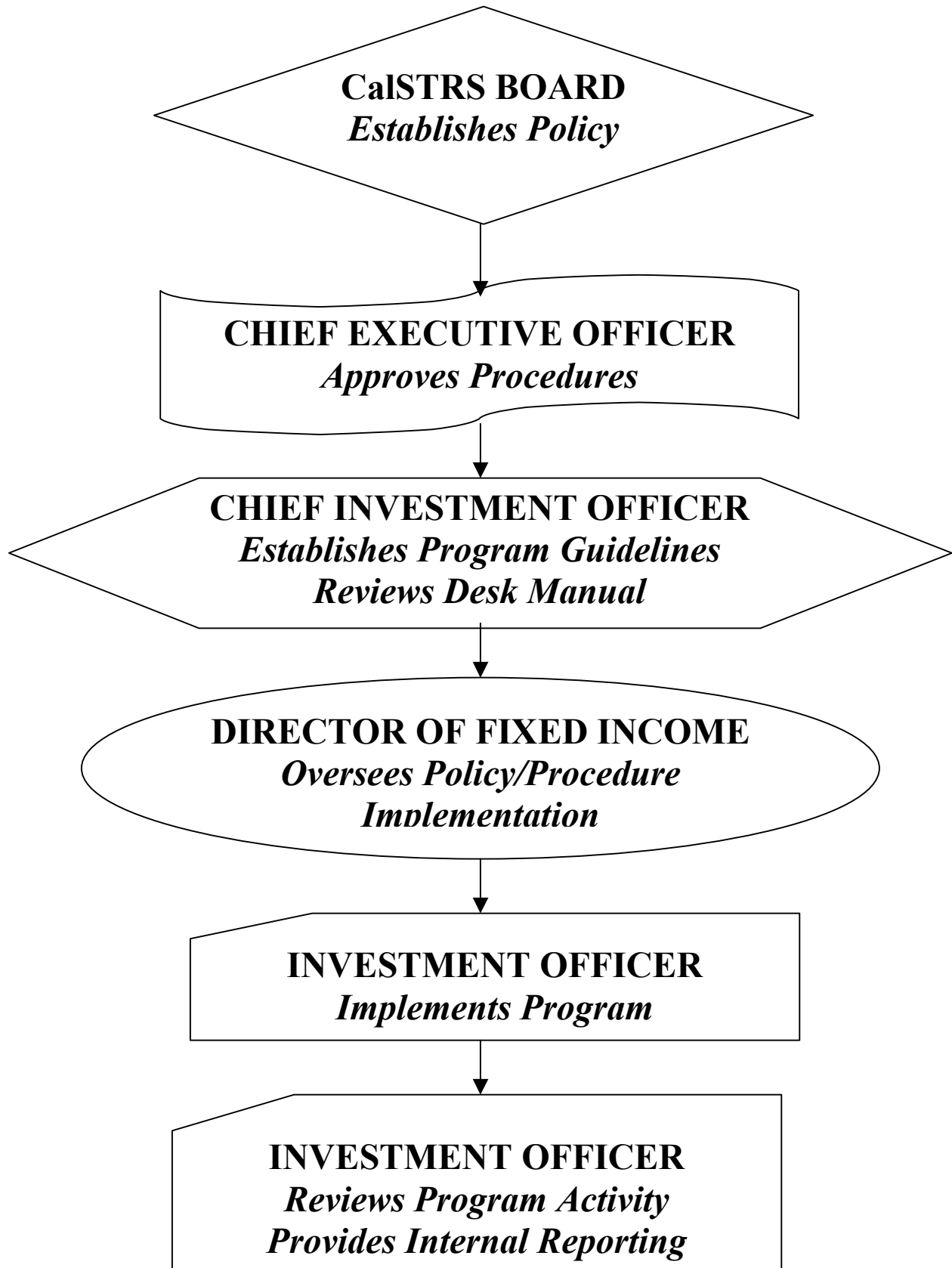
**California State Teachers' Retirement System
Currency Hedging Program
Policy Manual**

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California State Teachers' Retirement System
Currency Hedging Program
Policy Manual

FLOWCHART



**California State Teachers' Retirement System
Currency Hedging Program
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PROPOSED
RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Fixed Income – Currency Hedging Policy Revision

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the revised Currency Hedging Program Policies and has heard oral presentations from Staff; and

WHEREAS, Staff and Pension Consulting Alliance have recommended the adoption of the revised Currency Hedging Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the revised Currency Hedging Policies.

Adopted by:
Investment Committee
on December 4, 2002

Jack Ehnes
Chief Executive Officer